THE WALL STREET JOURNAL.

It's the Dollar, Stupid

By Judy Shelton
March 5, 2008

When the United States broke up the Bretton Woods international monetary system on Aug. 15, 1971, it marked the official end of an era when the dollar was literally "as good as gold." President Nixon's announcement -- that the U.S. would no longer permit foreign central banks to redeem U.S. dollars for gold at the established fixed rate -- shocked Japan and Europe, our main overseas trade partners.

It was the repudiation of a formal agreement hammered out some 27 years earlier at Bretton Woods, N.H., and signed by delegates from 29 participating nations. The whole purpose of the agreement -- which was initiated by the U.S. -- was to establish a stable, post-World War II monetary foundation so that free trade could flourish. Never again would nations shortsightedly cheapen their currencies to obtain an unfair advantage; the nightmare of economic warfare leading to military warfare would be ended.

Today, our trade partners are no longer shocked. They have come to expect domestically focused monetary policy from America. But they are deeply concerned by the demise of the once-dependable dollar and deeply impacted by the economic distortions caused by skewed exchange rates. They are, no doubt, deeply affronted by what they detect as the same cavalier attitude that decades earlier prompted Nixon's Treasury Secretary, John Connally, to quip to U.S. allies: "It may be our currency -- but it's your problem."

Has the U.S. forever given up on the dream of a rules-based monetary order for a global economy dedicated to free trade? Have we abandoned all sense of duty associated with providing the world's key reserve currency?

These days it's easy to forget that, during the Great Depression years leading to World War II, floating exchange rates were not considered the free-market approach to currencies. They were considered the antithesis of global monetary order. Whereas the international gold standard guaranteed a level playing field in the trade arena, facilitating market-based outcomes among well-intentioned competitors in an open global marketplace, a nation that devalued its money against gold -- i.e., floated its currency -- was considered to be cheating.

Monetary manipulation was akin to moving the goalposts, an attempt to increase exports of your country's goods by rendering them less expensive when calculated in foreign currencies. Other nations responded with protectionist tariffs on imported goods and tit-for-tat currency devaluations of their own, strangling international trade and worsening the downward economic spiral.

Historical perspective is critical to understanding where we are now -- and what our nation may be facing even as we evaluate leading presidential contenders.

Money meltdown is not some remote topic to be relegated to abstruse scholarly articles published by universities, think tanks, and global institutions such as the International Monetary Fund. (Especially not the IMF, which long lost its mandate to preserve the Bretton Woods system of fixed exchange rates.) The consequences of currency chaos affect the personal fortunes of millions of individual citizens; once unleashed, it can spawn social resentments and political upheavals that change the destiny of whole nations.

We need to ask Sens. Barack Obama, Hillary Clinton and John McCain what they would do -- if anything -- to restore the integrity of the dollar as a meaningful unit of account, a reliable store of value. Would they put forward any new proposals for more comprehensive international monetary reform?

Given that Sen. Obama has garnered the support of Paul Volcker, the highly-respected former chairman of the Federal Reserve under Presidents Carter and Reagan, U.S. voters are apt to get a meaningful and well-considered reply. "I think we are skating on increasingly thin ice," Mr. Volcker noted in the Washington Post in April 2005. He warned that the stagflation of the 1970s was characterized by "a volatile and depressed dollar, inflationary pressures, a sudden increase in interest rates and a couple of big recessions." Mr. Volcker's solution? Act now to comply with "the oldest lesson of economic policy: a strong sense of monetary and fiscal discipline."

On the broader issue of global monetary reform, Mr. Volcker's ideas are less orthodox, more visionary. "My sense is that if we are to have a truly globalized economy, with free movement of goods, services and capital, a world currency makes sense," he stated in January 2000. "That would be a world in which the objectives of growth, economic efficiency and stability can best be reconciled."

Sen. McCain, for his part, suffers from an embarrassment of riches when it comes to economic advice.

One of his chief advisers is former Sen. Phil Gramm, a budget-balancing fiscal conservative with a Ph.D. in economics. Mr. Gramm is a disciple of the late Milton Friedman -- the Nobel laureate who furnished the academic rationale in the 1960s for ditching Bretton Woods and letting currencies float -- and might thus be expected to oppose any sweeping reforms to international monetary relations. Yet he has consistently emphasized the need "to refocus the IMF on its core mission of short-term lending to address financial and monetary instability." He considers protectionism "immoral."

Another McCain adviser, Jack Kemp, champions tax cuts and pro-growth policies over budgetary rigidity. A hero of the supply-side movement whose tireless efforts helped to bring about the Reagan boom of the 1980s, Mr. Kemp has never shied away from bold proposals.

Testifying before Congress in 1999, he criticized protectionist instincts that were misdirected at free and open trade "instead of the real source of the problem -- an international monetary arrangement of floating currencies in which no currency is linked to a stable anchor and all countries are tempted to use currency devaluation as an economic policy instrument during times of economic duress." Mr. Kemp's favored economic scholar is Robert Mundell, who received his Nobel for historical research on the operation of the gold standard and his theory of optimal currency areas. Considered the intellectual father of the euro, Mr. Mundell believes gold could be used as a reserve asset in a reformed international monetary system for the 21st century.

If the reality of a collapsing dollar and foreign exchange turmoil starts to bite consumers where they keep their pocketbooks -- for example, if the U.S. finds it necessary to raise interest rates to entice foreigners to buy the government bonds that finance our deficit -- the affects of currency misalignment could quickly move from the realm of dry treatises to the hyperactive world of live, televised political debate. Media consultants may grow apoplectic at the thought of having to reduce seemingly complex options into clever sound bites: Does the candidate advocate a new global monetary order linked to a universally-recognized reserve asset as a mechanism to guard against tinkering by self-serving governments? ("Gold: Money We Can Believe In.") Or is it possible to defend the existing, do-your-own-thing approach to currency relations, which undermines stable trade and capital flows at the expense of global prosperity? Meanwhile, foreign-exchange market specialists earn big profits by gambling -- some $3 trillion daily -- on where currencies might go next.

It's time the candidates devote less time on the minutiae of configuring the next economic stimulus package, or renegotiating the North American Free Trade Agreement. They should be thinking about how they will confront the imminent global currency crisis.

It's the dollar, stupid.